Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: September 1, 2023—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.4%. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a higher open.

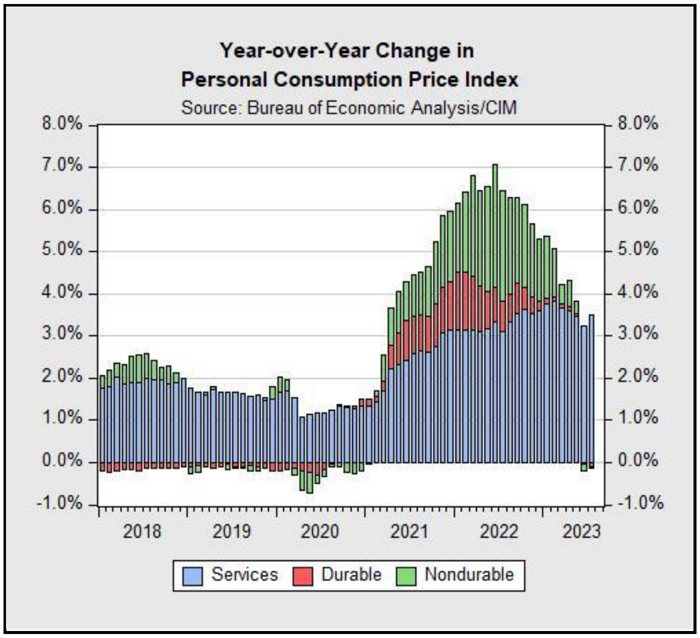
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (8/21/2023) (there will be no podcast for this report): "Reflections on the New Cold War"
- *Weekly Energy Update* (8/31/2023): We take a short look at the forecasts for oil demand and note that a major oil ETF is reverting to an earlier method of managing its investment in various contract months. We also note that one reason why Iran prefers to live under sanctions is that it benefits those in power. Saudi Arabia is wooing both the U.S. and China to build nuclear power. Also, a coming battery glut may be looming as China steps up production.
- *Asset Allocation Quarterly – Q3 2023* (7/20/2023): Discussion of our asset allocation process, Q3 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q3 2023 Rebalance Presentation* (8/18/2023): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Asset Allocation Bi-Weekly* (8/28/2023) (there will be no podcast for this report): "Examining the Rise in T-Note Yields"
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"

Good morning! Today's *Comment* will contain three themes: 1) Why Thursday's inflation report is unlikely to change central banks' rate decisions later this month; 2) How China's new map complicates its effort to build a coalition of emerging economies to challenge the G-7; and 3) How political brinkmanship is preventing the U.S. from addressing its debt problems.

Hold the Pause: Central bankers continue to leave the door open for another rate hike later this year despite signs of a slowdown in economic activity and price pressures.

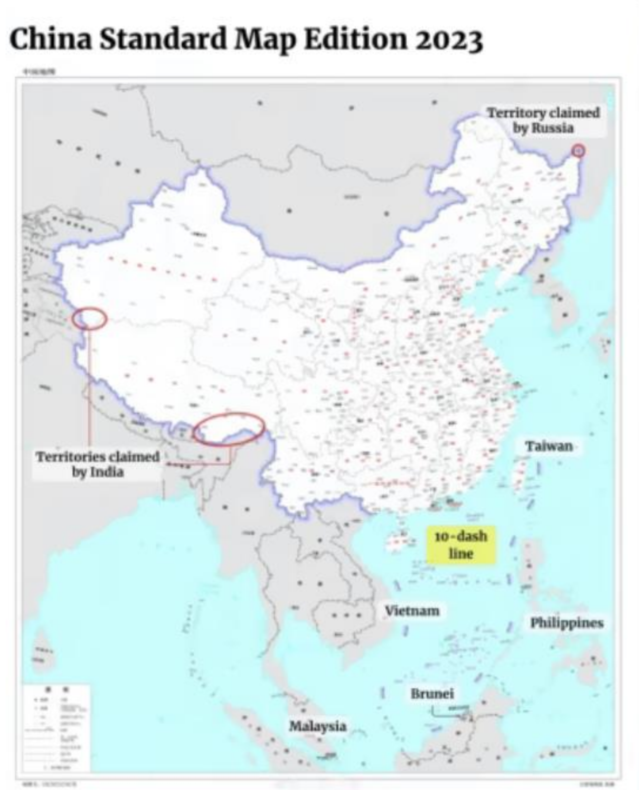
- The Federal Reserve's preferred inflation gauge, the PCE price index, rose 3.3% in July from a year ago, and was up from 3.0% in June. Core PCE inflation, which excludes food and energy prices, rose 4.2% year-over-year, up from 4.1% in June. The increase in headline PCE inflation was driven primarily by persistently high housing and utilities prices, which were impacted by base effects. However, the increase in core PCE inflation was not as large, suggesting that underlying inflation pressures may be starting to ease. In July, the annualized monthly change in headline and core PCE inflation was 2.6% and 2.5%, respectively.
- Preliminary data showed that inflation in the euro area stagnated in August. The annual change in the region's Consumer Price Index (CPI) rose 5.3% from the prior year, in line with the previous month's reading. Much of the rise in inflation in the region was driven by energy. Core CPI, which excludes energy and food, slowed modestly from 5.5% to 5.3%. Despite inflation still being more than double the central bank's 2% mandate, there are signs that price pressures are easing. Monthly data showed annualized core inflation slowed from 4.54% to 3.46% last month.



- The inflation report is not expected to sway policymakers' rate decisions. Although goods inflation has been declining, services inflation remains a problem. Service inflation accounted for nearly all of the increase in the July PCE report and still outpaces the overall CPI index in the euro area. This is likely to remain a significant concern for central bankers as they decide whether to raise rates at the next two meetings. We expect that there is, at most, one hike remaining this year, with rate increases being a toss-up next year as countries weigh the likelihood of a downturn.

China Playing Defense: Beijing is seeking to avoid isolation in the Indo-Pacific after releasing a controversial map that claims territory from several of its neighbors.

- China released a new national map on Monday, claiming disputed territory in the South China Sea and land territory also claimed by India. The map has been met with criticism from several countries, including the Philippines, Malaysia, and India. Beijing has defended the map, saying it is simply correcting what it sees as misrepresentations of its territorial borders. However, the map has further inflamed tensions between China and its neighbors and has raised concerns about China's growing assertiveness in the region. In a sign of Beijing's dissatisfaction with India's objection to its new map, Chinese President Xi Jinping has decided not to attend the G-20 meeting in New Delhi next week.
- To prevent other rifts from escalating, China has made overtures to its rivals, offering to mediate tensions and taking other steps to improve relations. In mid-August, Chinese and U.S. military officials met at a defense conference in Fiji to restore dialogue following former House Speaker Nancy Pelosi's decision to travel to Taiwan last August. China had also backed a three-way summit that included South Korea and Japan that would encourage cooperation between the three countries. These moves suggest that China still favors soft power projection as its primary way to influence countries, even when it has disagreements with them.

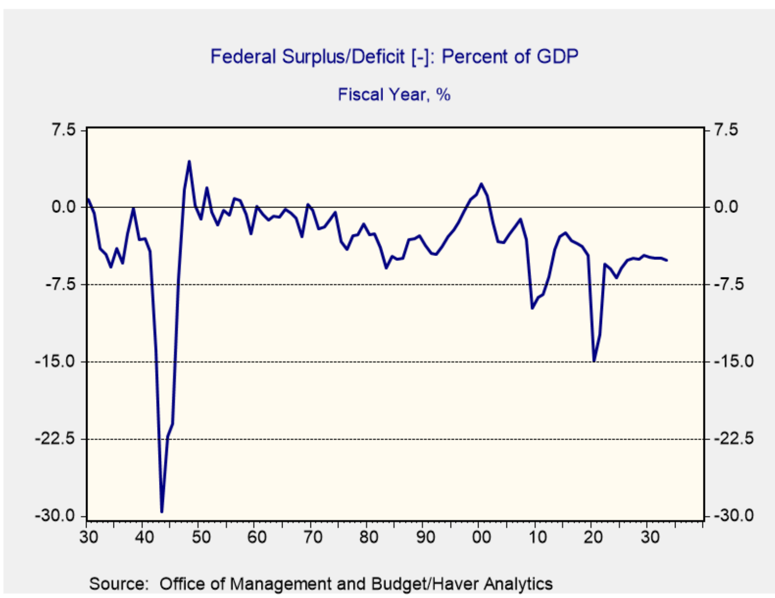


(Source: Channel NewsAsia)

- China's decision to release a controversial map of the disputed border with India just days after President Xi and Indian Prime Minister Narendra Modi agreed to have their officials handle the issue is a clear sign that China is not yet ready to lead a bloc of countries. The map is a provocation that will only further alienate India and other countries in the region. Furthermore, China's insistence on historical revisionism and its unwillingness to compromise on territorial disputes will make it difficult to build trust and cooperation with its neighbors. As a result, Beijing will have a hard time corralling its coalition partners behind any effort to challenge the United States directly in the Indo-Pacific.

Budget Bickering: The United States is on track for another budget showdown next year, which could further raise market concerns about the country's growing deficits.

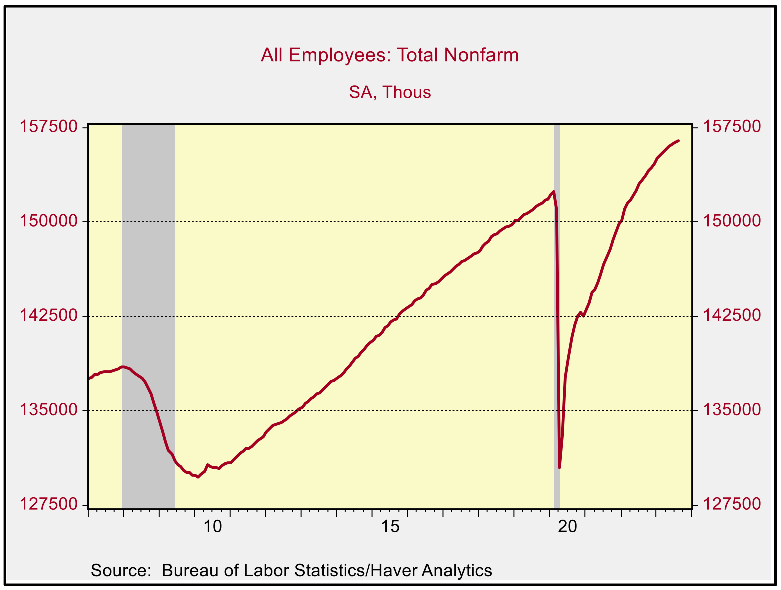
- The Biden administration formally requested a short-term spending extension from Congress on Thursday to avert a government shutdown on October 1. The request is likely to face opposition from the House Freedom Caucus, which is rallying Republicans to withhold support for any funding bill that does not include spending cuts and changes to border policies. Congress has yet to approve any of the 12 annual spending bills that typically fund the government. The showdown reflects the growing polarization in American politics, which has led investors to question the country's willingness to honor its debt commitments.
- The ongoing political gridlock in Washington has angered credit ratings agencies. Last month, Fitch Ratings became the second credit rating firm to downgrade the United States since S&P Global did so 12 years ago. The agencies are concerned that political brinkmanship will prevent the two sides from addressing the country's deficit problem, which now stands at $1.4 trillion and is expected to grow even larger. Higher interest rates and a potential recession could exacerbate fears of debt levels getting out of control, as both could add to the growing mismatch of funding and spending.



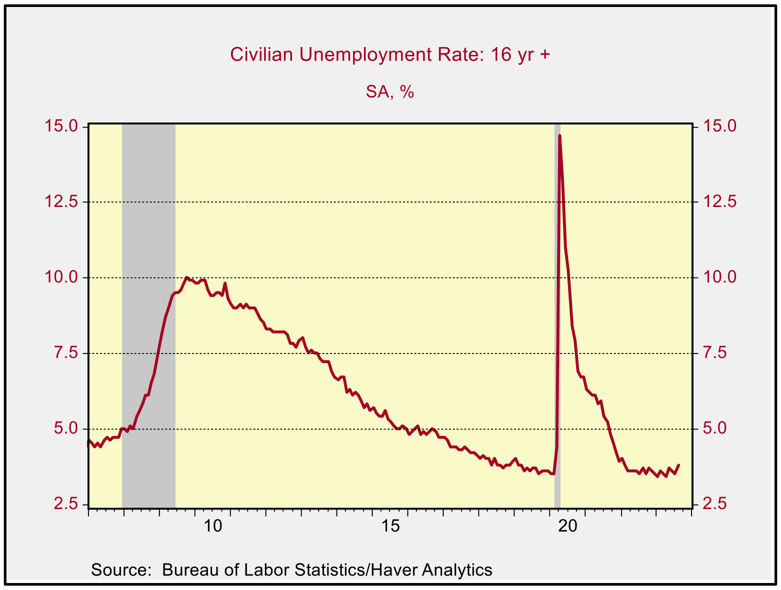
- Tackling the deficit will be a difficult task for either party in power. Neither side has the political will to make the tough decisions necessary to address the issue, such as reducing popular entitlement programs or raising taxes. However, the longer they delay action, the worse the problem will become. The government's inability to tackle the deficit is one of the reasons why long-term Treasury yields are likely to be higher in the future and the dollar will weaken against other global currencies, as the rising debt burden will undermine the U.S.'s credibility as a suitable reserve currency.

U.S. Economic Releases

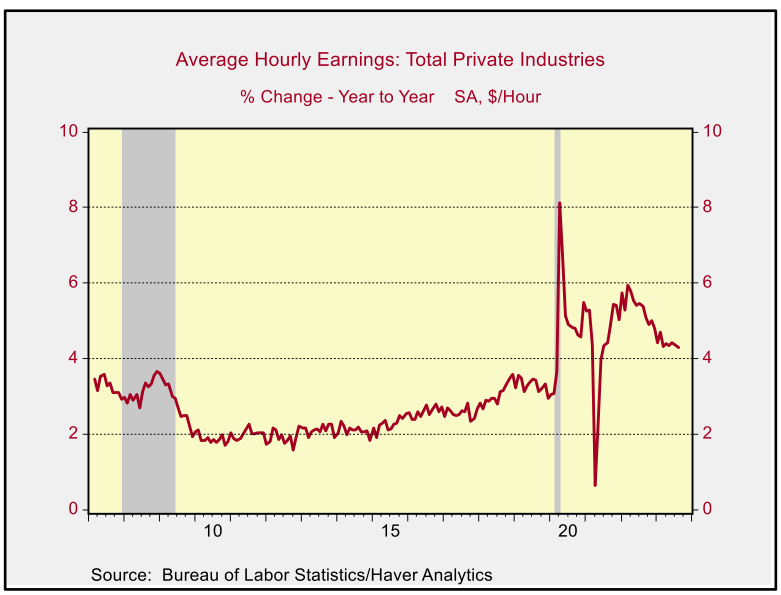
August ***nonfarm payrolls*** rose by a seasonally adjusted 187,000, modestly beating the expected gain of 170,000 and accelerating from the downwardly revised increases of 157,000 in July and just 105,000 in June. Almost all the job gains last month were in the private sector, including a jump in manufacturing payrolls. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



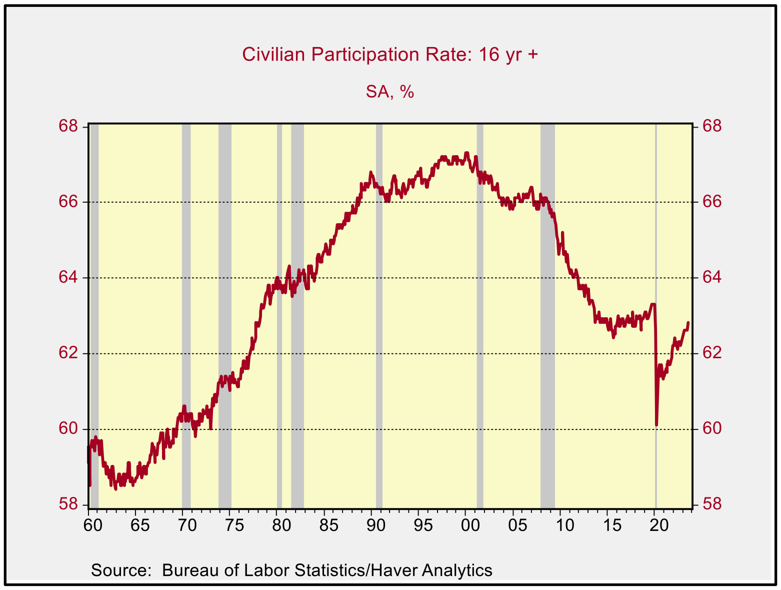
Perhaps most striking, the report also showed the August ***unemployment rate*** jumped to a seasonally adjusted 3.8%, far worse than expectations that it would be unchanged at 3.5%. The report suggests that the jump in the jobless rate came about because new entrants surged into the labor force, but many failed to find jobs. In any case, the unemployment rate now at its highest level since February 2022. The following chart shows how the unemployment rate has evolved since just before the Great Financial Crisis.



Still, despite the apparent cooling in labor demand, ***average hourly earnings*** in August rose to a seasonally adjusted $33.82, up 4.3% from the same month one year earlier. The annual gain was exactly as anticipated, marking only a slight deceleration from the 4.4% rise in the year to July. The chart below shows the year-over-year growth in average hourly earnings since just before the Great Financial Crisis.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The August ***labor force participation rate (LFPR)*** rose to a seasonally adjusted 62.8%, above expectations that it would be unchanged at July's rate of 62.6%. That means the LFPR is now very close to the 63.3% that it had reached in early 2020, right before the coronavirus pandemic. If so, the labor shortages of the last couple of years may finally start to ease, which would likely discourage labor hoarding, slow down wage growth, and put less upward pressure on consumer price inflation. The chart below shows how the LFPR has changed over the last several decades.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P Global Manufacturing PMI	m/m	Aug F	47.0	47.0	***
10:00	Construction Spending MoM	m/m	Jul	0.5%	0.5%	**
10:00	ISM Manufacturing Index	m/m	Aug	47	46.4	**
10:00	ISM Prices Paid	m/m	Aug	44	42.6	**
10:00	ISM Employment	m/m	Aug		44.4	**
10:00	ISM New Orders	m/m	Aug		47.3	**
	Wards Total Vehicle Sales	m/m	Aug	15.50m	15.74m	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:45	Loretta Mester Speaks on Inflation	President of the Federal Reserve Bank of Cleveland				

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications, and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Capital Spending	y/y	2Q	4.5%	11.0%	7.8%	***	Equity bearish, bond bullish
	Jibun Bank Manufacturing PMI	m/m	Aug F	49.6	49.7		***	Equity and bond neutral
New Zealand	ANZ Consumer Confidence Index	m/m	Aug	85.0	83.7		**	Equity and bond neutral
South Korea	Exports	y/y	Aug	-8.4%	-16.5%	-16.4%	***	Equity and bond neutral
	Imports	y/y	Aug	-22.8%	-25.4%	-22.9%	**	Equity and bond neutral
	Trade Balance	m/m	Aug	$870m	$1630m	$1652m	*	Equity and bond neutral
	S&P Global Manufacturing PMI	m/m	Aug	48.9	49.4		***	Equity bearish, bond bullish
China	Caixin Manufacturing PMI	m/m	Aug	51.0	49.2	49.0	***	Equity bullish, bond bearish
India	S&P Global Manufacturing PMI	m/m	Aug	58.6	57.7		***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Manufacturing PMI	m/m	Aug F	43.5	43.7	43.7	***	Equity and bond neutral
Germany	HCOB Manufacturing PMI	m/m	Aug F	39.1	39.1	39.1	***	Equity and bond neutral
France	HCOB Manufacturing PMI	m/m	Aug F	46.0	46.4	46.4	***	Equity and bond neutral
Italy	HCOB Manufacturing PMI	m/m	Aug	45.4	44.5	45.5	***	Equity and bond neutral
	GDP WDA	y/y	2Q F	0.4%	0.6%	0.6%	***	Equity and bond neutral
	PPI	y/y	Jul	-13.8%	-8.2%		**	Equity bullish, bond bearish
UK	Nationwide House Price Index	y/y	Aug	-5.3%	-3.8%	-4.9%	***	Equity and bond neutral
	S&P/CIPS Manufacturing PMI	m/m	Aug F	43.0	42.5	42.5	***	Equity and bond neutral
Switzerland	CPI	y/y	Aug	1.6%	1.6%	1.5%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Aug	1.9%	2.1%		**	Equity and bond neutral
	Core CPI	y/y	Aug	1.5%	1.7%	1.5%	*	Equity and bond neutral
	Manufacturing PMI	m/m	Aug	39.9	38.5	40.5	***	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	25-Aug	$580.5b	$579.5b		***	Equity and bond neutral
	S&P Global Services PMI	m/m	Aug	52.7	52.1		**	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	25-Aug	18.62t	18.72t		*	Equity and bond neutral
AMERICAS								
Brazil	GDP	y/y	2Q	3.4%	4.0%	2.7%	**	Equity bullish, bond bearish

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

doe	Today	Prior	Change	Trend
3-mo Libor yield (bps)	567	568	-1	Up
3-mo T-bill yield (bps)	529	531	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	540	540	0	Up
U.S. Libor/OIS spread (bps)	542	542	0	Up
10-yr T-note (%)	4.09	4.11	-0.02	Flat
Euribor/OIS spread (bps)	380	380	0	Up
Currencies	Direction			
Dollar	Flat			Flat
Euro	Flat			Up
Yen	Up			Down
Pound	Flat			Up
Franc	Flat			Up

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$87.74	$86.83	1.05%	
WTI	$84.51	$83.63	1.05%	
Natural Gas	$2.77	$2.77	-0.11%	
Crack Spread	$32.21	$31.79	1.31%	
12-mo strip crack	$28.40	$27.97	1.54%	
Ethanol rack	$2.44	$2.44	0.00%	
Metals				
Gold	$1,945.26	$1,940.19	0.26%	
Silver	$24.66	$24.44	0.90%	
Copper contract	$388.40	$382.20	1.62%	
Grains				
Corn contract	$483.25	$478.25	1.05%	
Wheat contract	$609.50	$602.00	1.25%	
Soybeans contract	$1,382.50	$1,368.75	1.00%	
Shipping				
Baltic Dry Freight	1,086	1,094	-8	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-10.6	-2.2	-8.4	
Gasoline (mb)	-0.2	-1.3	1.0	
Distillates (mb)	-1.2	-1.0	-0.2	
Refinery run rates (%)	-1.2%	0.5%	-1.7%	
Natural gas (bcf)	32	29	3	

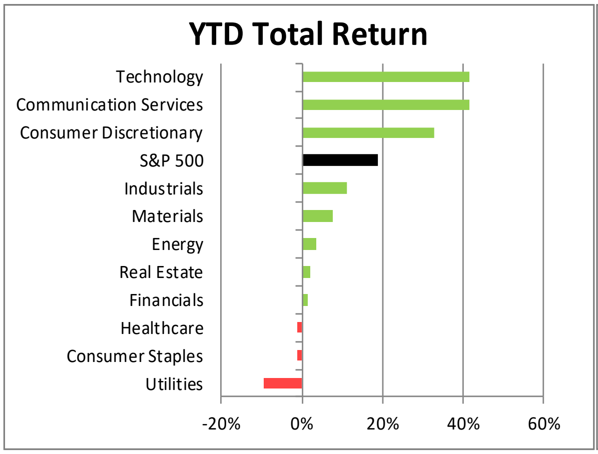
Weather

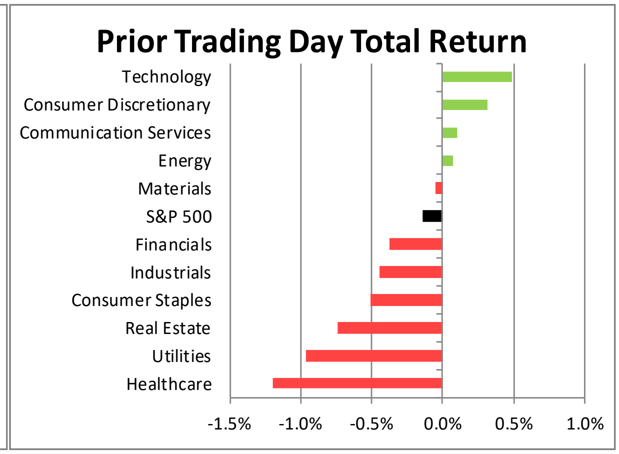
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country from the Rocky Mountains eastward, with below-normal temperatures only in the Pacific Northwest. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, with dry conditions precipitation outlook in the Southwest and the Mississippi Valley region.

There are currently five atmospheric disturbances in the Atlantic Ocean area. Hurricane Idalia, now a tropical storm, is starting to dissipate as it heads into the central Atlantic Ocean. Hurricane Franklin is now well east of Bermuda and heading into the northern Atlantic. Tropical Storm Jose is moving northward through the central Atlantic, as is Tropical Depression Gert. Finally, there is a disturbance off the coast of western Africa that is assessed to have a 100% chance of developing into a cyclone in the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/31/2023 close)

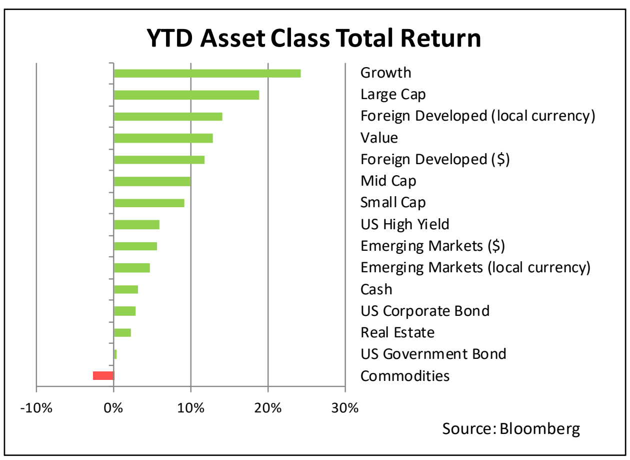




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 8/31/2023 close)

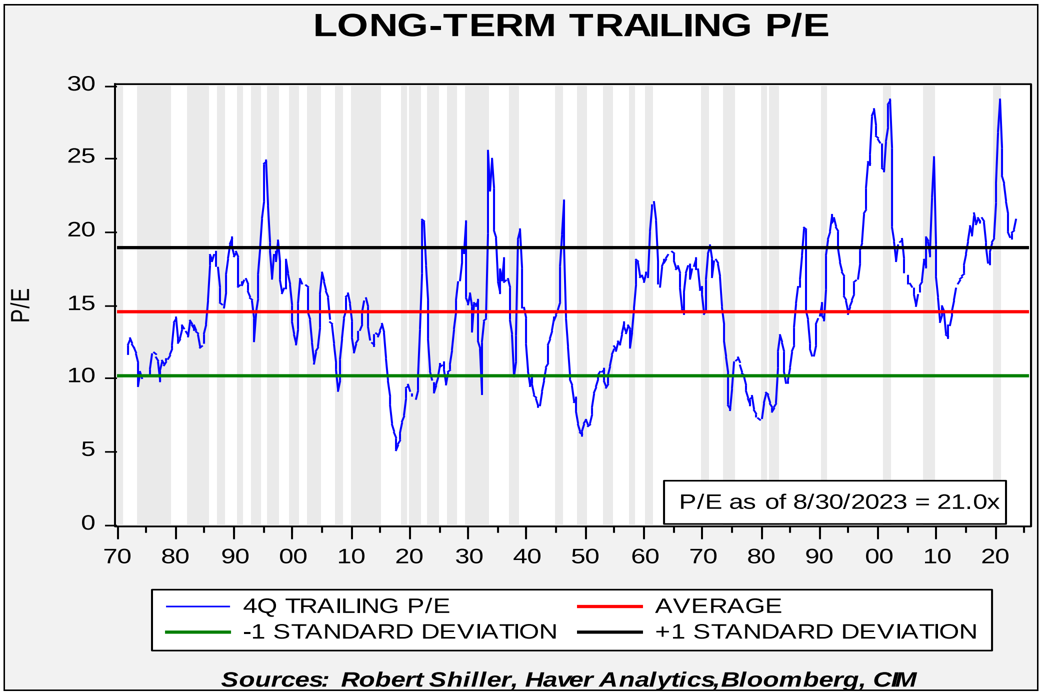


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index), Value (S&P 500 Value), Growth (S&P 500 Growth).

P/E Update

August 31, 2023



Based on our methodology,[1] the current P/E is 21.0x, down 0.1x from last week. Improved earnings coupled with falling index values led to the modest decline in the multiple.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the Bloomberg estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q3 and Q4) and two estimates (Q1 and Q2). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a long-term dataset for P/E ratios.